

October 19th, 2012

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington DC 20551

Via Facsimile 202-452-3819

Via E-mail regs.comments@federalreserve.gov

RE: Basel III Docket No. 1442

Ms. Johnson:

On behalf of First National Nebraska, Inc. and its affiliate banks¹ we are commenting on the Agencies' three joint notices of proposed rulemakings ("NPRs") to implement agreements reached by the Basel Committee on Banking Supervision in Basel III: *A Global Regulatory Framework for More Resilient Banks and Banking Systems*, December 2010 ("Basel III"), consistent with the provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA").

The focus of this letter are the provisions of the NPRs that most directly impact First National Nebraska, Inc. and its subsidiary banks. Prior to commenting on those specific provisions, we would like to make the following broad points:

- We support the Agencies endeavor to strengthen the industry's capital regime in a prudent and well thought out manner.
- **Based on our interpretation of the NPRs, we estimate that we will have to cut projected loan growth over the next five years by between 15 and 20% to meet the guidelines.** The Agencies have indicated they believe the industry can essentially "earn" its way into the enhanced capital standards. That is appropriate in our case and we will accomplish this goal through reductions in our growth plans. However, we encourage the Agencies to be transparent about the related cost to banks, the industry and the overall economy. As currently written there appears to be as an improper balance of economic cost beyond the systemic reward and a material potential impact on the economy as a whole.
- Before the NPRs are promulgated, we encourage the Agencies to reassess and balance the intended and unintended consequences. Based on the number of comment letters submitted to

¹First National of Nebraska, Inc. (Omaha, Nebraska with total assets of \$15.0 billion) and its five nationally chartered banks, First National Bank of Omaha (Omaha, Nebraska with total assets of \$13.1 billion, including a national credit card portfolio of \$4.3 billion), First National Bank (North Platte, Nebraska with total assets of \$437 million), First National Bank South Dakota (Yankton, South Dakota with total assets of \$380 million), First National Bank and Trust Company of Columbus (Columbus, Nebraska with total assets of \$367 million), and Fremont National Bank and Trust Company (Fremont, Nebraska with total assets of \$317 million) and its one state charter, Platte Valley State Bank & Trust Company (Kearney, Nebraska with total assets of \$413 million),

date, the time between the closing date for comments (October 22nd, 2012) and the proposed international implementation date of January 1st, 2013 appears unrealistically short.

- The unintended consequences, particularly the adverse impact on economic potential, is further exacerbated by the fact that the industry is still in process of digesting the impact of the Dodd-Frank legislation, for which, as of October 1st, 2012, 77% of the rules assigned to the Bank regulators remain incomplete.
- We believe Basel III should be restricted to systemically important financial institutions. The extension of Basel III to almost all banking entities in the USA is inappropriate and reflects an extension of the intent of the original Basel process far in excess of its goal to protect the global economy from the effects of problems within systemically important financial institutions. If there are concepts within Basel III that might be deemed appropriate for all segments of the industry, there are ways other than a blanket implementation to accomplish this goal.
- The proposals included in both the NPRs under discussion include “phase-in” periods. The intent of the period is to permit the institutions time to prepare for full compliance with the new requirements. While it would be appropriate for an examination team to review and inquire as to an institution’s plans for compliance and assess its likelihood for success; historic experience would seem to suggest that the Agencies are moving beyond this and expecting compliance with new levels many months before actual compliance is required.. This will be especially true in how the agencies look at voluntary compliance with the proposed RWA changes in the Standardized NPR, that specifically state that organizations may choose to comply prior to the 1/1/2015 effective date. It would be helpful to the industry if the Agencies would issue guidance to its field examiners on the appropriate way to assess and handle phase-in periods.

Comments on Specific Provisions of the NPRs:

Basel III NPR:

Phase-out of Trust Preferred Securities:

With the passage of the Dodd-Frank Act, the Congress of the United States enacted protections for certain institutions to retain the benefit of Trust Preferred Securities. This was a heavily discussed topic and once passed was incorporated into the capital strategies of impacted organizations. We find it troubling that within several years, the Reserve Bank should be seen to be changing legislation through regulation and permitting international agreements to usurp the primacy of federal legislation. First National of Nebraska will see a capital reduction of some \$150 million as a result of the effective repeal of the Collins Amendment.

The Capital Proposal takes a more conservative approach to the phase-out of TruPS and other non-qualifying capital instruments than the Dodd-Frank Act requires of depository institution holding companies with less than \$15 billion in total consolidated assets and depository institutions in general. In the Collins Amendment, Congress explicitly grandfathered the Tier 1 capital status of debt or equity instruments (such as TruPS) issued before May 19, 2010 by depository institution holding companies of under \$15 billion as of December 31, 2009. These smaller institutions have

relied on such instruments being grandfathered since the enactment of the Dodd-Frank Act, and it is unfair to subject such smaller institutions to additional, unexpected capital planning hurdles in an environment where the ability to raise additional capital is ever more constrained, especially when they will be competing with larger institutions forced to resort to the capital markets as a result of the more aggressive phase-out schedule applicable to them. We believe that the NPR when finalized should fully recognize the intent of the Collins Amendment.

The Capital Conservation Buffer:

The concept of an institution holding sufficient capital to be deemed well-capitalized, but insufficient to pay dividends, certain payments on tier 1 instruments and share buybacks seems to create a definition without meaning. As the Agencies are well aware, market and supervisory preferences will force banking organizations to hold capital in excess of this de facto minimum, essentially leading to “buffers” being maintained in excess of the required “buffers.” If a bank is unable to generate returns to its investors or pay bonuses to its executives should it be deemed well-capitalized? Should there just be one minimum risk-based asset level and banks that fall below this should be subject to regulatory sanction. Our concern is that rather than recognize the value of the Capital Conservation Buffer, the regulatory implementation of the concept will result in an expectation of additional “informal” buffers on top of formal ones.

Unrealized Gains and Losses Flowing through Capital

The Capital Proposal contemplates the “flow through” to CET1 of all unrealized gains and losses on a banking organization’s AFS securities. Under the current risk-based capital rules, unrealized gains and losses on AFS debt securities (except for those caused by other than temporary credit agree impairments) are not included in regulatory capital, unrealized losses on AFS equity securities are included in Tier 1 capital, and unrealized gains on AFS equity securities are partially included in Tier 2 capital. We strongly believe that the AOCI filter should not be removed. If the Agencies nevertheless deem it appropriate to remove the filter, we propose delaying implementation of the AOCI adjustment until the Agencies have finalized rules to implement Basel III’s Liquidity Coverage Ratio. Finally, if the Agencies do not delay implementation, we argue that it would be more appropriate, at a minimum, to adjust capital in response to fluctuations in credit risk than interest rate risk.

It is clear that removing the AOCI filter would substantially increase the volatility of banking organizations’ regulatory capital ratios, vastly increasing the difficulty of predicting and managing capital adequacy. Although the practical consequences of this increased volatility are not yet completely evident due to the abnormally low interest rate environment, the filter’s removal would undoubtedly ripple through banking organizations’ entire capital framework, with the potential for significant negative effects.

Credit Enhancing Representations

Under the existing general risk-based capital framework, risk-based capital charges do not apply to residential mortgages once they are sold to third parties, even where the seller provides representations and warranties to take back mortgages that experience very early payment defaults (*i.e.*, within 120 days of sale of the mortgages) or that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation. The proposal fundamentally changes this framework by assigning new risk weights to certain off-balance sheet risks, including risks arising from certain credit enhancing representations and warranties for “pipeline” mortgages.

1. Early Payment Defaults

The proposal would change the current framework by treating representations and warranties for early payment defaults as off-balance sheet assets with a 100 percent credit conversion factor (CCF) applying to the value of the loans that are sold. The proposed rule expressly seeks comment on this fundamental change in the treatment of such representations and warranties.

We ask the Agencies to remove the capital charge for credit enhancing representations and warranties in the final rule.

2. Fraud and Misrepresentations

We also request the Agencies to make clear in the text of the final rule and the preamble to the rule that warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation are *not* subject to risk-based capital charges. The definition of “credit-enhancing representations and warranties” states that it does “not include warranties that permit the return of underlying exposures in instances of misrepresentation, fraud, or incomplete documentation.” However, the preamble to the rule is unclear and suggests that warranties for fraud, misrepresentation, and incomplete documentation might be subject to the 100 percent CCF and accompanying capital charge.²

Any potential argument that warranties for fraud, misrepresentation, or incomplete documentation are subject to capital charges would have a dramatic, detrimental impact on banks’ capital ratios because such warranties are held for the entire life of the loan. This approach would cause risk weighted assets to balloon by 500 percent and capital ratios to drop by more than 10 percent. We request that the Agencies to make clear in the final rule that such warranties are not subject to capital charges.

Deduction of Mortgage Servicing Assets exceeding 10% of CET1:

a) Rather than subjecting U.S. banks to the “worst of both worlds” in this case, we request that, if the Capital Proposal is implemented as proposed, the Agencies should not continue to impose the 10% FDICIA haircut. Section 475 of FDICIA, which imposes the haircut, also provides that MSAs may be valued at more than 90% of their fair market value if the Agencies jointly make a finding that such valuation would not have an adverse effect on the deposit insurance funds or the safety and soundness of insured depository institutions. We request that, given the cumulative effect of the proposed rules on the regulatory capital treatment of MSAs, and the fact that even without the 10% FDICIA haircut MSAs would nevertheless incur a higher capital impairment under the proposed rules than they do currently with the haircut, the Agencies should formally find that allowing a banking organization to include 100% of the fair market value of its readily marketable MSAs would not have an adverse effect on the deposit insurance funds or the safety and soundness of insured depository institutions, and revise the Capital Proposal to delete the relevant section.

² See *id.* at 39-40.

Standardized Approach NPR:

We would refer to our initial general points and suggest that the contents of this NPR also be confined to those banks which are defined as systemically important.

Residential Mortgages:

The changes proposed to Risk Weighted Asset definitions, when added to the significant increase in regulatory compliance costs associated with residential mortgage lending have the potential to be damaging to the overall economy during the fragile housing recovery. When taken into account with proposals for “ability to pay” and the concept of “safe-harbored products”, the changes in RWA on residential mortgage loans and specifically balloon loans seem over-burdensome and a way of controlling lending that should not be necessary. Accordingly, the final rule should be substantially changed to:

- Eliminate the distinction between category 1 and category 2 mortgages, and instead, maintain the current general risk-based risk weights for residential mortgages.
- If the two categories are maintained:
 - Grandfather all legacy exposures that would be deemed category 2 mortgages under the proposal;
 - Broaden the definition of category 1 mortgages to include qualified mortgages, [certain] interest-only and balloon payment mortgages, all standard, prudently underwritten adjustable and floating rate mortgages, all performing, seasoned loans, and HELOCs originated subsequent to the first lien mortgage;
 - Reduce the risk weights for category 2 mortgages so that they range from 50 to 150 percent (not 100 to 200 percent) and expand the number of LTV tiers to six (as proposed in 2008) from the proposed four in order to minimize cliff effects;
 - Clarify the term “loan modification or restructuring” to mean only formal adjustments to the terms and conditions of a loan agreement;
 - Broaden the exemption for Home Affordable Mortgage Program (HAMP) modifications to also exempt other loan modifications and restructurings that meet certain sustainability criteria;
 - Clarify the definition of what it means to “hold” a mortgage;
 - Treat separately first and junior lien mortgages on the same property held by the same institution so that the second lien mortgage, however small, does not “taint” the first in terms of the risk weight assigned to it; and
 - Reduce risk weights applicable to junior lien mortgages.
- Recognize private mortgage insurance (PMI) at the individual and pool-wide level.

- Clarify that the new capital rules on credit enhancing representations and warranties would not apply to originated mortgages sold to third parties; alternatively, substantially reduce the risk weight for such representations and warranties.

Set forth in more detail below are the concerns precipitating the request for these changes, as well as more detail about each proposed change to the NPR.

Commercial Real Estate Credits for land acquisition and development

A) General Proposal:

The proposal assigns a new, 150 percent risk weight to high volatility commercial real estate (HVCRE). HVCRE is defined as “a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property,” and excludes one- to four-family residential properties as well as certain commercial real estate projects with low loan-to-value ratios and borrower investment.³

The proposal’s treatment of HVCRE, as modified by its exclusions, appropriately recognizes that different types of commercial real estate (CRE) lending present different types and levels of risk. But this recognition of risk-differentiation does not go far enough. In particular, the proposed rule should also (1) clarify that the definition of HVCRE does not include completed, income-earning loans; (2) exclude properties that meet a debt service coverage ratio (DSCR) of 1.0 from the definition of HVCRE; and (3) exclude certain small dollar owner-occupied CRE from the definition of HVCRE;.

B) Clarify Definition of HVCRE

The proposal defines HVCRE as “a credit facility that finances *or has financed* the acquisition, development, or construction (ADC) of real property.” This definition could be read to encompass ADC loans through the entire life of the loans, including after the property has been completed and tenants occupy the building.

We request that the final rule make clear that HVCRE does not include completed, income-earning loans. We believe that this limited definition of HVCRE is consistent with the actual risk profile of ADC of real property: Although ADC loan exposures present unique risks during the development and construction stages, these risks plainly decrease once the underlying property has been completed and is ready for tenant use. At that point, expenditures shift from construction costs to tenant improvements and building operations, and risk substantially decreases from development risk to cash flow risk. Therefore, banks should be permitted to reevaluate ADC loans after the underlying property has been completed and treat such loans as general corporate exposures, like other CRE loans, rather than higher risk-weighted HVCRE exposures.

C) Exclude Properties that Meet Certain Debt Service Coverage Ratios

The proposal risk weights all HVCRE at 150 percent regardless of the risk characteristics of the borrower. This approach is inconsistent with industry practice and does not accurately reflect the actual risk of the transaction. Moreover, the high risk weight associated with

³ *Id.* at 26, 171.

HVCRE raises the costs of borrowing for all HVCRE borrowers, even those with low risk characteristics.

To account for the lower risks associated with certain borrowers, we urge the exclusion of ADC property from the definition of HVCRE for a borrower that has a debt service coverage ratio (DSCR) of at least 1.0. A DSCR of 1.0 or greater indicates that the borrower has sufficient cash flow to meet annual principal and interest payments, and thus, presents a lower risk of default than other HVCRE borrowers. CRE loans to such low risk borrowers instead should be risk weighted as a general CRE loans at 100 percent. This lower risk weight appropriately reflects the actual risk of such a loan and also prevents unnecessarily increasing the cost of borrowing for such borrowers.

D) Exclude Certain Owner-Occupied Properties

We also urge the Agencies to exclude owner-occupied CRE with a loan amount of less than \$1 million from the definition of HVCRE. Most small dollar owner-occupied CRE loans are made to small businesses that occupy the underlying property to operate their business. The riskiness of such loans depends primarily and fundamentally on the success of the business, not on the development and construction of the property. Consistent with this risk profile, banks underwrite owner-occupied CRE loans of less than \$1 million in a manner similar to corporate loans. Such loans should therefore be excluded from the definition of HVCRE and instead treated the same as general CRE loans with a 100 percent risk weight.

90 Day past due exposures:

The Standardized Approach NPR proposes to assign a 150 percent risk weight to an exposure that is 90 days or more past due or on nonaccrual (and that is not guaranteed, not secured, not a sovereign exposure, and not a residential mortgage exposure). This treatment is fundamentally inappropriate because it ignores (1) the independent requirement to increase loss reserves for past due loans; and (2) the required 100 percent *deduction* from capital for certain of those increased loss reserves.


Banks increase loan loss reserves when loans become delinquent, independent of risk-based capital standards, and external auditors and agency examiners carefully review such increased provisioning to ensure that loan loss reserves are adequate. Such increases in reserves effectively increase the loss-absorption capacity of the bank in the same way as increased capital. Thus, requiring higher risk weights for past due loans, which at the margin would result in higher capital for such loans, effectively results in a kind of double counting of the increased loss absorption capacity already resulting from provisions to the loan loss reserve for the very same loans. Moreover, loan loss reserves exceeding 1.25 percent of standardized assets are separately required to be *deducted* from Tier II capital. In such circumstances, requiring higher risk weights for delinquent loans while at the same time deducting from capital the provisions associated with such loans would result in an even greater degree of double counting.

In this context, further increasing the risk weight for past due exposures—in addition to increasing associated reserves and the potential capital deduction for such reserves—effectively double-counts the risk of default for delinquent loans. As a result, the risk weight for such loans should not be increased to 150 percent.

Conclusions:

We appreciate the opportunity to provide these comments on behalf of First National Nebraska, Inc. and its subsidiary banks. We acknowledge the difficulty of conforming Basel III rules to DFA. In this context, we do not support a "one size fits all" approach. Rather, we believe the NPRs need to be revised in a fashion that balances the quality and quantity of capital with the very real impacts to the industry and economy.

Sincerely



Michael A. Summers
Chief Financial Officer



Nicholas W. Baxter
Senior Vice President & Chief Risk Officer